

## Profiting from Precaution

### How China's Policy Banks Can Enhance Social and Environmental Standards

Kevin P. Gallagher

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## About the Author

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### Kevin P. Gallagher

Kevin P. Gallagher is associate professor of International Relations at Boston University, where he is Co-Director of the Global Economic Governance Initiative. He is the co-author of *The Dragon in the Room: China and the Future of Latin American Industrialization* and other books. Gallagher is co-chair of the university's Pardee Task Force on Regulating Global Capital Flows.

He serves on the investment subcommittee of the US Department of State's International Economic Advisory Committee, as an advisor to the Investment Division of the United Nations Conference on Trade and Development, is an editor at the *Review of International Political Economy*, and is a member of the China-Latin America Working Group at the Inter-American Dialogue. He has served as a visiting or adjunct professor at Tsinghua University (China), El Colegio de Mexico (Mexico), Cedes (Argentina), and the Fletcher School of Law and Diplomacy at Tufts University.

Gallagher is also a senior research associate at the Global Development and Environment Institute at Tufts University. He writes regular columns on global economic and development policy for the *Financial Times*, among others.

## Introduction

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China's policy banks—China Development Bank (CDB) and China Export-Import Bank (China Ex-Im Bank)—are new leaders in the world of sovereign finance. Within a decade, they have surpassed levels of annual lending by the World Bank and many other counterparts. The *Financial Times* estimates that China's policy banks provided some \$110 billion in financing to developing countries between 2009 and 2010 compared to the World Bank's \$100 billion.<sup>1</sup> Between 2003 and 2011, these two Chinese banks provided some \$79 billion to Latin America, compared with \$57 billion by the World Bank, surpassing even the \$78 billion lent by the Inter-American Development Bank (IDB).<sup>2</sup>

Through this lending, China's policy banks are helping, in particular, to fill the global infrastructure gap. And this is an area where, until recently, the international financial institutions (IFIs) have paid less attention.

But viewed through another lens, Chinese overseas finance tends to concentrate in sectors and areas that generate environmental degradation, as well as conflicts with local communities. This, in turn, has prompted an occasional backlash. So to continue expanding China's access to these markets, and to

better understand risk in such markets, China's banks will need to ramp up safeguards for the environmental and social aspects of their lending.

The policy banks came into being amid a series of Chinese financial reforms in 1994. Their creation was, in theory, intended to free the "big four" Chinese banks—Bank of China, China Construction Bank, Agricultural Bank of China, and Industrial and Commercial Bank of China—from the responsibility of lending to support the state's policy objectives. And this restructuring did allow the four major banks to act, to a greater degree than previously, as commercial entities. CDB and China Ex-Im Bank, meanwhile, assumed a more significant role in explicitly supporting the government's policy objectives through their lending.

Today, CDB is responsible for the design and execution of China's many local government financing vehicles (LGFVs), sometimes known as Local Investment Corporations (LICs), that have channeled billions of dollars into infrastructure, real estate, and urbanization projects across the country.<sup>3</sup>

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Still, although these two policy banks focus primarily on strengthening the Chinese industrialization process, each has a slightly unique mandate. For its part, CDB supports China's macroeconomic policies—laid out in the State Council's successive Five-Year Plans—focusing in areas such as electric power, roads, railways, petroleum and petrochemicals, coal, posts and telecommunications, agriculture, and related industries. China Ex-Im Bank, meanwhile, exists mainly to enable trade for Chinese firms and products and to assist Chinese firms in obtaining overseas investment opportunities. China Ex-Im Bank achieves these objectives by providing export credits to Chinese firms, loans to overseas construction and investment projects, and concessional loans to foreign governments.

The Chinese government's "Going Out" (*zouchuqu*) policy of the last decade has now brought China's commercial and policy lending to the international stage, with CDB alone having approximately \$150 billion of more than \$1 trillion total loans going overseas as of 2011.<sup>4</sup> New estimates through 2012 put CDB and China Ex-Im Bank finance in Africa and Latin America at upwards of \$140 billion in lines of credit, commitments, and loans to these two regions.<sup>5</sup>



The Chinese banks' liberal purse strings have been largely embraced by host country governments that have had trouble accessing international capital markets and lending from the international financial institutions for projects in infrastructure, energy, and mining. Yet some Chinese projects have met with political and social resistance in host countries on grounds that Chinese

lending practices do not incorporate adequate social and environmental safeguards.

To help narrow this gap and encourage improved environmental standards worldwide, this

policy memorandum identifies Chinese overseas environmental standards and compares them to those of the Western-backed lenders. The memorandum also aims to demonstrate why meeting—and beating—domestic and global environmental standards could be a shrewd business decision for China and its banks.

Following, but then also enhancing, established best practices with respect to the environment could, in fact, enable more market access for Chinese investments, reduce risks to Chinese lenders, and have a salutary effect on the global image of China's policy banks and the country itself.

## The Policy Problem: A Gap in China's Safeguards

China's policy banks have *already* established a series of environmental and social guidelines for their overseas operations, and this is remarkable given China's level of per capita income, now at \$8,400 in purchasing power terms.<sup>6</sup> In contrast, the World Bank and other IFIs had not even begun to contemplate incorporating such guidelines into their lending until their principal Western contributors were much further along in the development process.

Many IFI projects were met with stiff resistance by host country governments and civil society organizations on social and environmental grounds, and this has, to this day, tainted their reputation and legitimacy in some countries. In an effort to repair that image, the IFIs now have a comprehensive set of guidelines in place that have proved to be beneficial for their continued relationships with host country governments and for the profitability of their projects.

But at this point, Chinese institutions' lending guidelines appear, from the standpoint of safeguards for the environment, to be less robust than those of their Western-backed counterparts. So upgrading such guidelines would serve two goals simultaneously: (1) it would enable them to incorporate sustainability

and environmental goals into their lending practices, and (2) it could be an important tool for China's policy banks to continue to gain market access and mitigate risk as they seek to expand their overseas operations.

### **CDB Guidelines**

In comparing CDB's environmental guidelines alongside those of the World Bank and the International Finance Corporation (IFC), which is the World Bank Group's private financing arm, the Chinese lender currently incorporates four of the social and environmental guidelines commonly accepted by leading IFIs (see Table 1). These guidelines include:

environmental impact assessment (EIA), project review, compliance with host country environmental laws and

regulations, and an ex-post EIA. Interestingly, CDB is the only leading development bank, even including the IFIs, that requires an ex-post EIA. In fact, this CDB requirement is an improvement over current IFI guidelines because it creates a formal review process of a given project's overall effect on both community and environment, thus allowing for future corrective action.

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**Table 1: CDB and IFI Environmental Guidelines Compared**

Environmental Guidelines	World Bank	IFC	CDB
Ex-Ante Environmental Impact Assessment	X	X	X
Project Review of Environmental Impact Assessment	X	X	X
Industry-Specific Social and Environmental Standards	X	X	
Ensure Compliance with Host Country Environmental Laws and Regulations	X		X
Ensure Compliance with International Environmental Laws and Regulations	X		
Public Consultations with Communities Affected by the Project	X	X	
Grievance Mechanism	X	X	
Independent Monitoring and Review	X		
Establishing Covenants Linked to Compliance	X	X	
Ex-Post Environmental Impact Assessment			X

Source: Gallagher et al. (2012), *The New Banks in Town: Chinese Finance in Latin America*, Inter-American Dialogue, Washington, DC.



Like a number of Chinese firms, CDB has also worked to increase transparency by publishing an annual corporate social responsibility (CSR) report on its website in both English and Chinese. As a result of the bank's

efforts, the Chinese government has held up CDB as a domestic model, giving it

numerous Chinese awards, including five consecutive "People's Social Responsibility Awards," "Most Socially Responsible Bank of the Year" in 2010, and "Most Socially Responsible Corporation in 2010."

But CDB has yet to receive equal praise in its overseas activities and projects. This may be because five widely-accepted international practices have not yet been incorporated into CDB guidelines:



*The overall environmental standards applied by CDB are the host country's standards, which, in many cases, are generally lower and less restrictive than international environmental laws and regulations.*

consultation with domestic constituencies, a grievance mechanism, a requirement for adherence to international environmental laws and regulations, an independent review and assessment, and the

establishment of covenants linked to compliance.

Three of these guidelines—public consultation, a

grievance mechanism, and an independent review and assessment—are especially important avenues for addressing public concerns and ensuring transparency throughout the lending process. What is more, the overall environmental standards applied by CDB are the host country's standards, which, in many cases, are generally lower and less restrictive than international environmental laws and regulations.

### **China Ex-Im Bank Guidelines**

China Ex-Im Bank has also incorporated EIA, project review, public consultations with communities affected by the project, and an ex-post EIA into its social and environmental guidelines. According to an unofficial translation of China Ex-Im's 2007 "Guidelines on Environmental and Social Impact Assessment of Loan Projects," the bank stipulates the requirement of an ex-ante EIA and further states that "those projects that are harmful to the environment or do not gain endorsement or approval from environmental administration will not be funded."<sup>7</sup>

**Table 2: Environmental Guidelines of Two Export-Import Banks Compared**

Environmental Guidelines	US Ex-Im Bank	China Ex-Im Bank
Ex-Ante Environmental Impact Assessment	X	X
Project Review of Environmental Impact Assessment	X	X
Industry-Specific Social and Environmental Standards	X	
Ensure Compliance with Host Country Environmental Laws and Regulations	X	X
Ensure Compliance with International Environmental Laws and Regulations	X	
Public Consultations with Communities Affected by the Project	X	X
Grievance Mechanism	X	
Independent Monitoring and Review	X	
Establishing Covenants Linked to Compliance	X	X
Ex-Post Environmental Impact Assessment	X	X

Source: Gallagher et al. (2012), *The New Banks in Town: Chinese Finance in Latin America*, Inter-American Dialogue, Washington, DC.

And also like CDB, China Ex-Im Bank requires an ex-post EIA. Based on the findings of this ex-post EIA, China Ex-Im Bank is required to “revise the measures taken before and during the project implementation for similar projects. If necessary, the related requirements and policies will be fully revised.”

In contrast to other IFIs or the US Ex-Im Bank, China Ex-Im does not cite any

financial threshold that applies to its EIA (see Table 2). This omission could broaden the EIA screening process to cover a greater number of projects. China Ex-Im Bank has also made efforts to increase transparency by publishing an overview of major projects and a CSR section in its annual report, available on its website in both English and Chinese.



China Ex-Im Bank goes beyond CDB in its guidelines, including by requiring public consultations and project review during the duration of the loan and by establishing covenants linked to compliance. Therefore, the discovery of negative environmental impacts prior to and during the course of the project will lead China Ex-Im Bank to “require the implementation unit to take immediate remedial or preventive measures. Otherwise, they will discontinue financial support.” These additions are a step forward for socially and environmentally responsible lending because they directly link China Ex-Im Bank’s loans to the meeting of guidelines.

Yet despite these additions, China Ex-Im Bank’s guidelines remain relatively limited. The bank has yet to require adherence to international environmental laws and regulations, a grievance mechanism, or independent review and assessment. These additional requirements would provide an avenue for mitigating any potential social disruptions and

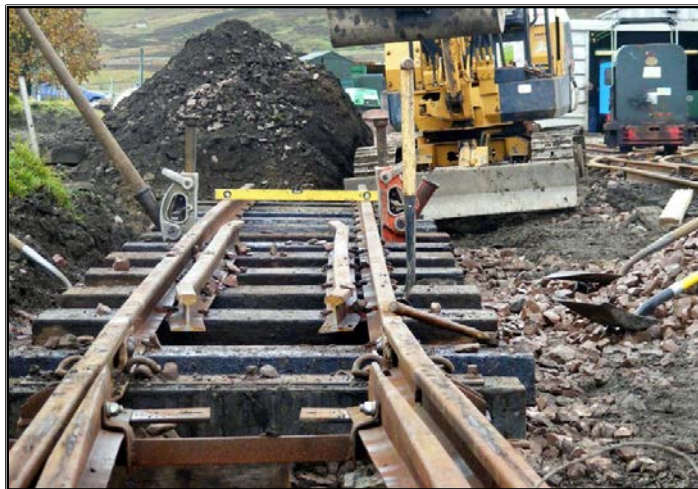
environmental concerns that emerge during the duration of a project.

The bottom line is that China’s guidelines, as presently constituted, are running ahead of historical norms but, when viewed from the standpoint of environmental protection and sustainability, still lag behind competitors on the global stage. What is more, China’s

banks do not practice public disclosure with regard to the implementation of these guidelines. For instance, neither the CDB nor the China Ex-Im Bank websites list in Chinese or English the

findings of the very EIAs they themselves require for their major projects. And very few of these EIAs have been obtained publicly by other means.

Such efforts, including a public release of EIAs, would help China to compete on the same terms as global competitors. But more than this, they could help mitigate risk to Chinese lenders by strengthening *public* confidence in host countries, thus bolstering the political position of both the Chinese banks and recipient governments.



## Why Upgrade? To Compete Abroad and at Home

Put more bluntly, upgrading the environmental and social guidelines of China's policy banks will have broad political resonance in host countries, especially among public stakeholders, who, as witnessed in Gabon in recent years, have become increasingly vocal and empowered around the world.

So upgrading to compete would have two useful effects for China's principal overseas lenders:

First, it could help to sustain existing markets while also positioning these banks to secure future market access. Adopting and then adhering to stronger, broader, and deeper guidelines can help secure long-term relationships with host governments in regions across the world. The public record of protest and criticism in some countries makes clear that certain projects have been perceived by host country publics to flout environmental norms, resulting in denial and/or delay of contracts.

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*Adopting established international norms could also help China's policy banks to secure markets in developed countries.*

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One example is the Belinga iron ore deposit in Gabon, which was contracted in 2007 between the government in Libreville and the Chinese firm China Machinery Energy Corporation with financing from China Ex-Im bank. The project sparked significant local protest over its environmental impact, and, as a result, has been perpetually renegotiated and delayed and may ultimately be denied.

Another example is CDB's multibillion dollar China-Myanmar oil and gas pipeline projects, which have received similar local scrutiny. The "Shwe" gas project is coordinated by China National Petroleum Corporation (CNPC), which has contracted some operations to Sinohydro. Local civil society organizations in Myanmar have mounted protest campaigns against several issues: land confiscation with limited compensation; a prospective loss of livelihoods that will result for local populations; the role of Myanmar security forces in protecting the project; deforestation; river dredging; and chemical pollution.<sup>7</sup>



Photo: © Curt Carnemark / World Bank

A third example is the Patuca hydroelectric project in Honduras, supported by China Ex-Im Bank and operated by Sinohydro. Approved by the Honduran government in 2011, one of the projects is said to entail flooding 42 km of rainforest slated to be part of Patuca National Park and the Tawahka Asangni Biosphere Reserve. The project was initially denounced in 2011 by local civil society organizations, which cited the shaky foundations of the EIA that had been published for the project. But many other nongovernmental organizations (NGOs), including international NGOs with a global presence, such as International Rivers and The Nature Conservancy, have also sought to reevaluate the project.<sup>8</sup> Such campaigns, uniting locally affected communities with globally recognized NGOs who have access to global media, have slowed projects and tainted investor images around the world.

To the extent that local skepticism and protests result in delays or even loss of projects, environment-related political risk can severely affect the bottom line of the major Chinese policy banks. Moreover, local publics in many countries increasingly look to international norms as

the basis for assessing reputational effects.

As a result, less comprehensive guidelines and standards are almost certain to become a challenge for CDB over time, as the bank expands its business presence abroad. International lending has been a fast-growing part of CDB's portfolio, with foreign currency loans (a rough proxy for overseas lending) more than doubling to \$150 billion in 2011.<sup>9</sup>

And adopting established international norms could also help China's policy banks to secure markets in developed countries. Chinese

banks clearly seek to further penetrate Organization for Economic Cooperation and Development (OECD) markets, such as the United States and Europe, where an even higher level of environmental and social standards exists. Establishing a track record of good practice in emerging markets and developing countries could help Chinese banks to assimilate, adapt, and ultimately incorporate such practices into their daily operations, an experience that could prove essential as they also seek to navigate markets in OECD countries.



Photo: NASA/GSFC/Jeff Schmaltz/MODIS Land Rapid Response Team

Over the long term, incorporating enhanced social and environmental standards could help China’s policy banks obtain reputational benefits and first-mover advantage in China’s domestic market as well. At a time when environmental concerns are growing and public consciousness about environmental impacts is rising rapidly at home, China’s policy banks could demonstrate their environmental stewardship in the domestic market by meeting heightened public expectations over environmental protection.

In policy terms, China is already making impressive strides in increasing environmental standards on the home front. But such standards require a learning curve in order for specific institutions to meet them, or lead the way to an even higher threshold. By assimilating standards from around the world, especially from countries where a higher level of regulatory scrutiny currently exists, China’s policy banks can be the first movers among Chinese financial institutions in bringing such experiences home, thus potentially defining a new source of long-term comparative advantage over domestic counterparts.

One example from another market illustrates how Chinese lending institutions might work with their corporate clients to bring international

practices home. It involves Mexico’s CEMEX company, a leading international producer of cement and building materials. And just as many Chinese firms are doing today, CEMEX “went global” in the 1990s. The firm sought to establish operations in the United States and Europe, where environmental regulations were very stiff compared to Mexico and other third-country markets where the firm already did business—for instance, in Latin America.

After some effort, CEMEX was able to meet environmental and regulatory standards in these OECD economies but then also “brought them home” to Mexico, where it then won many domestic awards for its performance. Such a reputation has helped CEMEX gain market access—and enhance its public reputation—at home, even as it won new markets abroad. China’s policy banks, working with their Chinese corporate clients, could be the intellectual and operational leaders in bringing the best standards to China and to Chinese firms’ operations abroad.

Beyond winning markets, however, enhanced environmental standards and adoption of international guidelines and best practices would have a second major effect as well. It could also help China’s policy banks mitigate project risk.

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Conducting ex-ante assessments and engaging with local authorities and governments could help China's banks to gauge a host country's potential concerns about pending projects. Adjusting the parameters of projects based on such information, but before a project starts, has often proved to be much less costly than discovering such concerns *after* the fact in more confrontational settings, possibly delaying projects for years.

This type of information is also useful for banks to identify potential liabilities ahead of project implementation. In Ecuador, for example, the US-based Chevron Corporation has been fined \$8.6 billion for liabilities incurred over the life of some of its projects in that country. One lesson for Chinese institutions, both financial and industrial, is that understanding host country laws, concerns, and ecosystems can help to avoid such actions. As many firms have discovered, violations can prove immensely costly.



## Options for Improvement

China has already made significant strides in establishing environmental and social guidelines. So the good news for those Chinese banks—and companies—that seek to become reputational and operational leaders in assimilating best environmental standards is that they already have an important foundation on which to build. It would not be difficult for Chinese institutions to take the next step, closing the standards gap with counterparts across the world.

Here are several approaches Chinese banks and firms could consider:

One option is to partner with, and learn from, international counterparts that have already discovered—the hard way—that not sticking to guidelines is bad for business. In effect, this would mean that Chinese policy banks and firms would increasingly seek partnerships in order to share political and other environment-related risks.

*Chinese policy banks should look to expand their environmental guidelines, broaden them, and make them more understandable to public stakeholders.*

One of several manifestations of that option is to establish joint platforms with other lenders. And this would build on existing experience: China Ex-Im Bank in 2012 established a \$1.8 billion private equity platform with the IDB to focus on infrastructure, natural resource, and equity investments in mid-cap companies in Latin America. China is providing the resources, while IDB has announced that the projects in the fund will follow the environmental safeguards established by IDB rather than those of China Ex-Im Bank.

This innovative joint IDB-China Ex-Im vehicle could become a model for China.



Photo: Trevor Samson / World Bank

Indeed, given the China Ex-Im Bank's financial contribution, the bank could, as the initiative develops, seek to have its own environmental experts work alongside IDB counterparts to study how they administer and implement safeguards. Such training and exposure to IDB practices could help accelerate the diffusion of new ideas throughout the Chinese partner bank.



Another model would leverage opportunities that may emerge from China Ex-Im Bank's reported collaboration with its US counterpart in Ghana to jointly finance that country's Sunyani Water Supply System Expansion and Rehabilitation Project. As shown in Table 2 above, China Ex-Im Bank guidelines are less robust than those of its prospective American partner, which is a leader in the area of environmental standards. The Chinese lender could create a partnership with US Ex-Im Bank similar to the one it has established with IDB, expanding this new bilateral effort to engage with the social and environmental aspects of the project.

Yet another model would involve expanded collaborations between Chinese lenders and Chinese corporates. China's policy banks could work in broadened ways with Chinese companies, many of which are bank clients and are already

adopting enhanced environmental standards in their own overseas operations. In Peru, for example, Chinese investment during the 1990s met with social and political resistance over mining operations, which saddled Chinese firms with a controversial reputation that subsequently made it difficult for other Chinese entities to further penetrate Peruvian markets.

But this has changed as Chinese firms have learned to better deal with political risks in

their new overseas operating environments. In Peru, Chinese firms have begun to obtain positive public feedback on some of their latest investments. In contrast to the 1990s, today's Chinese investments in Peru have better met the needs and expectations of local communities. And that has meant reduced political risk and social conflict when compared to previous years.<sup>10</sup>



Photo: © Curt Carnemark / World Bank

## Conclusion

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To be sure, Chinese institutions, including the two major policy banks, have sprinted ahead of the historical curve in their early adoption of environmental and social guidelines for their overseas operations. This is particularly true of some Chinese industrial companies, both private and state owned. However, in order to mitigate new political risks as their global footprint grows, and also to better compete in and access global markets, Chinese policy banks should look to returns.

expand their environmental guidelines, broaden them, and make them more understandable to public stakeholders.

By adopting enhanced practices, China's policy banks may do more than just run ahead of the historical norm. They could also become leaders themselves. They would become a flagship example of how emerging market policy banks that provide much-needed finance globally can also catalyze sustainable economic growth and earn healthy

## Endnotes

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<sup>1</sup> Dyer, Geoff, Jamil Anderlini, and Henny Sender, “China’s lending hits new heights”, *Financial Times*, January 17, 2011, accessed at <http://www.ft.com/intl/cms/s/0/488c60f4-2281-11e0-b6a2-00144feab49a.html#axzz2WCixDmDv>.

<sup>2</sup> Gallagher, Kevin P., Amos Irwin, and Katherine Koleski, *The New Banks in Town: Chinese Finance in Latin America*, Inter-American Dialogue, February 2012.

<sup>3</sup> Sanderson, Henry and Michael Forsythe, *China's Superbank: Debt, Oil and Influence - How China Development Bank is Rewriting the Rules of Finance*, 2013 Wiley, New York.

<sup>4</sup> Ibid.

<sup>5</sup> Brautigam, Deborah and Kevin P. Gallagher, *Bartering Globalization: China's Commodity Backed Finance in Africa and Latin America*, forthcoming 2013.

<sup>6</sup> World Bank Development Indicators (2011), accessed at <http://data.worldbank.org/indicator/NY.GDP.PCAP.PP.CD>.

<sup>7</sup> Banktrack-and Friends of the Earth (2012), *China Development Bank's Overseas Investments: An Assessment of Environmental and Social Policies and Practices*.

<sup>8</sup> International Rivers (2012), *The New Great Walls: A Guide to China's Overseas Dam Industry*, accessed at <http://www.internationalrivers.org/resources/the-new-great-walls-a-guide-to-china%E2%80%99s-overseas-dam-industry-3962>.

<sup>9</sup> Sanderson, Henry (2012), “China Development Bank’s Foreign Currency Loans Rise to \$150 Billion,” *Bloomberg News*, accessed at <http://www.bloomberg.com/news/2011-04-20/china-development-s-foreign-currency-loans-rise-to-150-billion.html>.

<sup>10</sup> Irwin, Amos and Kevin P. Gallagher (2013), “Chinese Mining in Latin America: A Comparative Perspective,” *Journal of Environment and Development*, 22(2), 207-234.

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Policy Memoranda offer background and analysis of a discrete policy challenge but, most important, offer realistic, concrete, and achievable prescriptions to governments, businesses, and others who can effect tangible and positive policy change.

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